CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 11, 2012

Don't Underestimate Mario Draghi

In the previous *Core Comments,* I quoted the comment of Mario Draghi, president of the European Central Bank (ECB), from late July that "the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." In the analysis presented in that letter, I argued that German opposition and the terribly difficult economic and fiscal problems facing many European countries would overwhelm the then-unexplained actions that Draghi was contemplating. As an investment matter, my skepticism about the European Central Bank's capacity to deliver a meaningful solution to the Eurozone problems led me to maintain the hedging positions in Core's clients' portfolios and to keep investment risk in portfolios low.

In the short run at least, I underestimated the power of Mr. Draghi's ECB. Mr. Draghi discussed his plans over the last several weeks and appeared to reach an agreement with German Chancellor Angela Merkel and others with a program that was announced formally on Thursday of last week. By this, the ECB will buy in the markets short-term (up to about 3 years in maturity) government debt of Spain, Italy, and other indebted countries. This buying is to be contingent upon agreements by the debtor countries to fiscal solvency conditions imposed by the European Union the International Monetary Fund (IMF) and the ECB, the so-called 'Troika.' This is a key provision, giving assurance to creditor countries like Germany that ECB support will only flow if and as the debtor countries submit to the austerity demands of the creditors. Moreover the bond purchases will be 'sterilized', i.e., the ECB will sell securities it now holds in amounts equal to those it buys in the markets, so as not to be 'printing money'. (The ECB's assets will not grow in amount, but they will deteriorate in credit quality, because it will be selling German bonds and other high-credit quality holdings as it buys Spanish and other low-quality bonds.)

Jens Weidman, president of Germany's Bundesbank and a member of the ECB's governing council, has been adamantly opposed--as have many Germans--to the buying of debtor countries bonds. He denounced the plan forcefully and repeatedly in recent weeks and cast the sole vote against it. Financial markets have seen it differently. Since Mr. Draghi's late July announcement and during his elaboration of plans in recent weeks, yields on two to three year Spanish and Italian bonds have fallen markedly, from above 6% in Spain's case to around 3% now. At the same time, stock markets generally have risen.

By

Jack Mayberry

Many impediments to European growth remain. The ECB's action will keep at relatively low levels the cost the 'peripheral' countries must pay to borrow in the short term. Lower borrowing costs lessen the impact of the austerity measures--higher taxes and lower government spending--that these weak countries

Soros' suggestion to Germany: 'Lead or Leave'

A point Soros makes is that the European Union is dividing into creditor and debtor countries, with somewhat punitive strictures being imposed on the latter by the former. This contrasts with the aspirational goals that informed the creation and development of the European Union, beginning with the European Coal and Steel Community through the launch of the Euro. The current situation compares, Soros reminds us, with the imposition of reparations on Germany after the First World War. The political unpopularity of the economic burden under which Germany suffered led, in a straight line to the rise of the Nazis and Hitler.

Soros suggests that Germany should be a 'benevolent hegemon' in the EU, or leave the Eurozone itself, perhaps with other creditor countries like the Netherlands and Finland.

must endure. But, because the ECB will only undertake the bond buying program for countries that accept the austerity strictures, Spain and Italy face the unpleasant task of consigning their people to a weaker economy, rising unemployment and less support for social services provided by the government. Tomorrow the German constitutional court is expected to rule on the constitutionality of the key pan-European rescue institution, the European Stability Mechanism. Imminent elections in the Netherlands and strident opposition in Finland to further support for the periphery threaten the complex process. The Troika's fraught decision to provide further funds to Greece lies ahead.

I am now persuaded that the ECB has the tools and the will to reduce risk of a systemic problem from the Eurozone problems, thus the title to this letter. An important effect of ECB bond buying in the secondary market will be improvement in the balance sheets of European banks. They will be able to sell their short-term bonds of Italy, Spain and others to the ECB at relatively favorable prices. This will reduce risk of major bank failures in Europe, decreasing risk to the global financial system. This appears to be a helpful plan; it demonstrates Mr. Draghi's political sophistication and abundant skills.

In this country, our central bank appears poised to commence its next round of monetary policy easing. Chairman Bernanke's speech last week in Jackson Hole and the weak employment report released on Friday point toward imminent action. Many doubt the effectiveness of the Fed's earlier rounds of monetary easing despite Mr. Bernanke's arguments. Most agree, however, that the actions support the financial markets and asset prices. We are in the process of lifting a portion of our hedging positions and investing somewhat more forcefully.

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In this extended aftermath of the financial meltdown in 2008, the Great Recession, continuing economic weakness, and fiscal policies tilted toward austerity in Europe and the United States, the role of the central banks is of paramount importance. Under Mario Draghi, the ECB has joined the Federal Reserve and the central banks of Japan and the UK in actions to sustain economies and the financial system. Given the extended periods in which short-term interest have been near zero, monetary policy has generally focused on support of longer-term bonds with the result that most 'risk' assets, including stocks, are indirectly but powerfully supported by the central banks. The dramatic approach of the ECB leads us to reduce our hedging position and add to our equity holdings, now in Germany's stock market. In the last year, our equity investments have been tilted toward US stocks and infrastructure development, while European stocks have, quite reasonably, been notably weak. The startling underperformance of European stocks make Germany attractive, despite the ongoing and still unresolved problems in Europe.

A rather long but extremely interesting analysis of the European crisis by George Soros appears in the current issue of the New York Review of Books. I attach the piece as a pdf; this is the link to it: http://www.nybooks.com/articles/archives/2012/sep/27/tragedy-european-union-and-how-resolve-it/?pagination=false&printpage=true. The web version has a brief preface discussing last week's ECB announcement, which came after the main article was published.

For the time being, Mr. Draghi has calmed the markets with another forceful move. Now attention shifts the United States and the 'fiscal cliff' that lies before us. The world's economy and its financial markets are hostages of the policy makers, themselves with differing goals, ideologies, and capacity to understand.

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